VZCZCXRO1569
RR RUEHCHI RUEHDT RUEHHM
DE RUEHJA #0361/01 2280903
ZNR UUUUU ZZH
R 160903Z AUG 06
FM AMEMBASSY JAKARTA
TO RUEHC/SECSTATE WASHDC 8887
RUEATRS/DEPT OF TREASURY WASHINGTON DC
INFO RUEHZS/ASSOCIATION OF SOUTHEAST ASIAN NATIONS
RUEHKO/AMEMBASSY TOKYO 9991
RUEHBJ/AMEMBASSY BEIJING 3604
RUEHBY/AMEMBASSY CANBERRA 9858
RUEHUL/AMEMBASSY SEOUL 3731
RUEHBR/AMEMBASSY BRASILIA 0186
RUEHBU/AMEMBASSY BUENOS AIRES 0039
RUEAIIA/CIA WASHDC

UNCLAS SECTION 01 OF 06 JAKARTA 010361

SIPDIS

SENSITIVE
SIPDIS

DEPT FOR EAP/MTS AND EB/IFD/OMA
TREASURY FOR IA-SEARLS
DEPARTMENT PASS FEDERAL RESERVE SAN FRANCISCO

E.O. 12598: N/A
TAGS: EFIN EINV ECON PGOV PREL ID
SUBJECT: INDONESIA'S FINANCIAL SECTOR POLICY PACKAGE

REF: JAKARTA 1833

¶1. (SBU) Summary. The Government of Indonesia issued its Financial Sector Policy Package on July 5, tackling two important issues of non-performing loans at state-owned banks, and insolvent insurance firms. Success in these areas will represent one of the most significant changes in the financial sector since the post-crisis restructuring. This is the third of three economic policy packages that included Infrastructure (issued in February) and the Investment Climate (issued in March). The Financial Sector Package was issued jointly by the Coordinating Minister for the Economy, the Minister of Finance, the State Minister of SOEs and the Governor of Bank Indonesia (BI). It is designed to showcase achievements and bolster the GOI's credibility on financial reforms. Like the other packages, the Financial Sector Policy Package is presented in matrix format: it has over 50 action items, each with a specified output, targeted timeframe, and responsible agency to address financial system stability; banking institutions; non-bank financial institutions; and capital markets. The matrix can be downloaded at from the Coordinating Ministry's website at
http://www.ekon.go.id/v3/images/stories/versi inggris1.pdf.
End Summary.

New Financial Sector Policy Package

¶2. (U) The Government of Indonesia issued its Financial Sector Policy Package on July 5, mainly tackling two important issues: non-performing loans at state-owned banks, and insolvent insurance firms. Success in these areas will represent one of the most significant changes in the financial sector since the post-crisis restructuring. President Yudhoyono noted in his August 16 annual policy speech that, "The Government and Bank Indonesia will continue to endeavor to perfect the policies, mechanisms, regulations, instruments and the quality of the economic institutions and the financial industry, such as, among others, stipulated in the package of policy reform in the financial sector. This measure is necessary so that our economy has a growing elasticity and resistance to fluctuations and uncertainties."

¶3. (U) This is the third of three economic policy packages

that included Infrastructure (issued in February) and the Investment Climate (issued in March). The package is divided into four principal chapters:

A) Financial system stability;
B) Banking institutions;
C) Non-bank financial institutions;
D) Capital markets.

A short, fifth section for "miscellaneous issues" addresses the privatization of state-owned enterprises and establishment of a National Export Financing Agency. The time horizon of the package runs through December 2007, but most measures are slated for action in 2006. Several tougher issues such as a tax policy for the financial sector, infrastructure financing, and improving SME financing were deleted but may reappear in a follow-on package next year. The Coordinating Minister plans to issue in 2007 a medium-term package mapping out financial sector reforms through the end of President Yudhoyono's term in ¶2009. A decree is in the works to establish an oversight committee to monitor Package implementation.

¶4. (SBU) Minister Boediono, as Finance Minister under then-President Megawati, issued transparent policy matrices like these to show Indonesia's commitment to reform after completion of its IMF program in December 2003. This package has been carefully designed to include achievable action items, many of which were already in train. Many items simply call for the MOF to "improve" a regulation or issue a decree, or for Bank Indonesia to issue a circular on a certain subject. In this respect, the package at least partly succumbs to the tendency of the bureaucracy to

measure implementation in terms of issuing official decrees, although we do not doubt the commitment of Coordinating Minister Boediono and in particular of Finance Minister Sri Mulyani to effecting tangible change.

Improving Financial System Stability and Oversight
--- -----

¶5. (SBU) The first section of the package deals with financial system stability, a goal reinforced by the currency mini-crisis of August 2005, which was exacerbated by a lack of coordination between the fiscal and monetary authorities. Our contacts at the International Monetary Fund (IMF) say it is unclear whether the package will actually improve policy coordination, noting Indonesia's tendency to "create domestic problems out of international shocks through a slow policy response." The package calls for the drafting of a Financial Sector Safety Net Law and its submission to Parliament by December 2006. In addition, the matrix echoes goals laid out in the State Ministry for National Development and Planning (BAPPENAS) National Medium Term Development Plan for 2004-2009 (issued as a Presidential Regulation in January 2005).

¶6. (SBU) The new package calls for the establishment of a long-discussed Financial System Stability Forum (FSSF), whose members will include the financial supervisory and regulatory agencies including BI, the MOF's Capital Markets and Financial Institutions Supervisory Agency (BAPEPAM-LK), and the Indonesian Deposit Insurance Agency (LPS). The FSSF will be charged with conceptualizing an Indonesian Financial System Architecture and establishing a Macro Early Warning System for disturbances in the financial sector. A senior international advisor in the Finance Ministry told us that the FSSF would normally sit within the Central Bank, but because Sri Mulyani does not trust BI, the forum is a hybrid and took two years of negotiations to finalize. Bank Indonesia and LPS signed an MOU to develop the FSSF on December 30, 2005 (reftel). On the same date, the Minister of Finance also issued a Decree on the Financial Safety Net (No 135/PMK 05/2005), in force until the new law is in

place.

¶7. (U) The proposed Financial Sector Safety Net Law would enhance the existing LPS law to help protect depositors from bank failures as well as protect the government from the risk of future bailouts. It also creates a formal mechanism between BI, the MOF, and the deposit insurance agency (LPS) for dealing with troubled banks. The GOI has been working on a financial sector safety net, consisting of a lender of last resort, deposit insurance agency, and institutional mechanism for dealing with distressed banks, since the financial crisis of 1997-98. Building blocks of the safety net have been covered by other laws, such as the phrase-out of blanket deposit insurance (completed) and creation of a consolidated regulatory and supervisory agency for the financial sector (not yet completed). (Note: The Financial Services Authority, or OJK, is mandated by Law 23/1999. End Note.)

Strengthening State-Owned Banks

¶8. (SBU) The main policy goal of this part of the package is to improve the performance of state-owned banks by resolving their NPLs. Bank Mandiri and Bank Negara Indonesia (BNI) are the principal targets of the measures elaborated in the package, having accrued large amounts of NPLs through years of lax governance, related lending, and poor risk management. The package includes smaller policy programs to professionalize the banking sector, such as expanding certification testing for basic banking operations, including risk management; improving methodologies for risk-based banking supervision; implementing formal Good Corporate Governance standards for commercial banks; and bringing Indonesia's new credit bureau, inaugurated in June, into line with international standards and expanding its access to information. BI Deputy Governor Maman Somantri told us he expects the credit bureau will be privatized in

two years. After the nascent mutual fund industry suffered losses of 70 percent last year over non-transparent pricing and risk, the package also calls for information transparency for banking products and other consumer protection measures. These include a standardized system for consumers to file complaints and the establishment of an independent dispute mediation body.

¶9. (SBU) Although Bank Mandiri and BNI lobbied BI to be allowed to establish special purpose vehicles that would take NPLs off their books, the policy actions will instead amend the rules governing NPLs. They will allow state-owned banks to work around state laws that have thus far prevented them from resolving bad loans using techniques commonly employed by commercial banks. Existing laws, such as the 2003 State Finance Law, treat state-owned banks assets as "state" assets. As a result, state-owned banks taking a haircut (loss) on non-performing debt or reselling it at a discount could be accused of causing a financial loss to the state, currently considered a criminal corruption offense. An international advisor at the Finance Ministry tells us that Bank Mandiri has been waiting for President Yudhoyono to sign the government regulation allowing state-owned banks to take haircuts on debt, which has been on his desk since the end of July.

¶10. (SBU) Getting rid of the NPLs is only half the battle, however. Resident expatriate economists note that because an excess of NPLs reflects a bank governance problem, bank management must be improved to prevent them from accumulating anew. Besides allowing the state-owned banks to resolve NPLs using techniques employed by commercial banks, the Package also urges they emulate the more professional management practices of their private sector counterparts. The package calls for the State Ministry of SOEs to "ensure the commitment of state-owned banks'

management to corrective measures in governance and risk management and to efforts for resolving problem loans." The medium specified for achieving this is the signing of management contracts on these subjects with the boards of directors of state-owned banks, a pretty weak mechanism for producing results.

¶11. (SBU) The Finance Ministry advisor characterized Bank Mandiri as "very cooperative" in reform efforts. A senior contact at Mandiri also pointed out that the bank's new president, Agus Martowardoyo, had replaced all the group heads at the bank, which took months. In contrast, BNI is not replacing key staff, suspended an audit that was undertaken 18 months ago, and has a disengaged board of commissioners. The IMF notes that BNI is bloated in terms of personnel, at two-thirds the size of Mandiri, and unlike the latter is still non-transparent about its NPLs.

¶12. (SBU) An international banking consultant told us that it is not only the old legacy loans that are problematic, such as the Mandiri loans that have been the subject of headlines in the past year. New loans are going bad at a worrisome tempo because banks do not have proper risk assessment procedures. The consultant lamented that at least a third of Mandiri's employees are corrupt, incompetent, or both, and estimated that some 40-50 percent of new SME loans are going bad because Mandiri still does not have good risk managers or account officers.

¶13. (SBU) Though the Financial Sector Package aims to improve the banks, some debtors still have an attitude inherited from the New Order, when one of the perks of crony capitalism was that it was understood that state-owned bank loans did not always need to be repaid. Our senior contact at Bank Mandiri told us in confidence that after Bank Mandiri tried a "name and shame" strategy earlier this year, publishing the names of problem-loan holders, some debtors had started to pay, some were paying only interest, and some who could pay have a bad attitude and are refusing to. Mandiri's actions provoked a backlash from some companies that reached out to Palace contacts in an attempt to get the President to intercede, which he declined to do on advice of Finance Minister Mulyani. We heard a similar story about

debtors with bad attitudes from the Finance Ministry advisor, who told us that Mandiri had "quite legally" seized a few cash deposits that were used as collateral on nonperforming loans. In one instance, the customer complained to the police, who hauled in several dozen Mandiri staff members including a director for questioning until 4 a.m. The advisor noted that in the past, Mandiri would have just made the problem go away by paying the police more than the client had, but now Mandiri's approach is to work things out through proper channels.

Bank Consolidation

¶14. (SBU) The Financial Sector package includes an item designed to encourage the consolidation of Indonesia's 131 banks required under BI's Indonesian Banking Architecture vision. The matrix calls for Bank Indonesia to provide "incentive" for banks to merge over the next two years, but does not explain what the incentive will be. BI has had trouble energizing its bank consolidation program, since the owners of small private banks like being bank proprietors, do not want to sell or close their banks, and are unlikely to respond to rational incentives. The large state-owned banks, however, have shown sustained interest over the past year or so in merging with each other, raising the undesirable prospect of too much banking sector concentration in precisely the segment that is most poorly managed. BI has rebuffed these proposals. However, BI's recently announced "single presence" policy, if it goes ahead, would bar investors from holding a majority ownership

stake in more than one bank. Designed to encourage consolidation (and possibly to mollify nationalists piqued at foreign investment in Indonesian banking), it is unclear whether the policy would apply to the government, which holds controlling stakes in the country's three largest lenders measured by assets-Mandiri, BNI, and Bank Rakyat Indonesia (BRI).

Next Up, Insurance Sector

¶15. (U) The third section of the package deals with non-bank financial institutions, with a marked focus on the insurance industry. (Note: Indonesia's insurance sector is in bad health and poorly regulated. Some domestic insurance companies were merely appendages of conglomerates. End Note.) The matrix calls for improved implementation of "Know-Your-Customer" principles across the non-bank sector; general moves to strengthen the pension fund sector, including drafting a development road map for the industry and good governance guidelines; and MOF decrees on strengthening the capital structure, regulation and supervision of finance companies and venture capital firms. Both insurance pension industries are underdeveloped in Indonesia, depriving the nation of good sources of long-term capital that could be invested in infrastructure. The insurance industry is small, according to the World Bank in January 2005, with assets equal to just 5 percent of GDP and 6 percent of total financial sector assets. The industry is also highly concentrated, with the ten largest insurance firms dominating three-quarters of the sector. The pension sector is similarly small, commanding only about 3 percent of financial system assets.

¶16. (SBU) Indonesia's insurance industry has made progress since international insurers Manulife (in 2002) and Prudential (in 2004), were declared "bankrupt" by the Indonesian court system on spurious grounds. Now the GOI is wrestling with genuinely bankrupt insurance firms, in particular, Bumiputra 1912, Indonesia's preeminent domestic insurance company. Bumiputra 1912 is "totally bankrupt," according to our insurance industry contacts, with premiums collected today being paid out tomorrow in claims. It should theoretically be shut down, but since it insures teachers and similar professions in the lower-to-middle class, the GOI is concerned about disruptive social consequences if the firm were allowed to fail. Upon discovering that Bumiputra 1912 is incorporated as

Indonesia's only mutual life insurance company, the GOI made an exception for mutual life insurance firms in the solvency law to avoid having to close Bumiputra down.

¶17. (SBU) Our insurance industry contacts note some concern among foreign insurance firms that GOI will ask them to rescue bad firms. The Minister of Finance apparently only learned recently that Bumiputra 1912 was insolvent, and that she and Isa Rachmatarwata, Director for Insurance at Bapepam-LK, are still trying to devise a strategy. The international advisor in the Finance Ministry commented that Director Isa "has inherited a real rat's nest" in the insurance sector, referring to the Bumiputra problem. The advisor told us that Isa has conferred with a World Bank actuary on the Bumiputra problem and believes the firm's deficit to be at least $500 million, but that international interest in buying into the firm should help resolve the situation. (Note: As part of the MOF's reorganization, the Capital Market Supervisory Agency, BAPEPAM, merged last year with the MOF's Directorate General of Financial Institutions, which supervised insurance, pensions, and other non-bank financial institutions, to form a consolidated regulator for all these institutions, now called BAPEPAM-LK, under the MOF. This merger is a transitional step toward the formation of the fully consolidated and independent regulatory body for financial

services or OJK, mandated under Law 23/1999. End Note.)

Capital Markets

¶18. (U) The section on capital markets includes a slew of measures to "develop," "improve," and "refine" supervision, infrastructure, systems and procedures. One noteworthy program aims to develop the secondary market for bonds, including better price discovery mechanisms, starting up a bond repo market, and establishing a primary dealer system for government bonds. All these measures would further GOI efforts to broaden and deepen the domestic capital market for better GOI debt management and deficit financing options in future. The MOF has already completed one action item on the matrix, the issuance of Indonesia's first-ever government retail bond (ORI). Most Indonesian citizens put their money into very short-term time deposits of 30 days. The government is promoting the three-year retail bonds to encourage the development of an "investment society" that will help finance national development through the capital markets. The small retail bond issue, originally targeted to raise only about $230,000, attracted strong interest. The GOI accepted all bids for a final issue of over $360,000 at the August 9 auction.

Privatization of SOEs

¶19. (SBU) The last section includes a couple of measures to further the politically sensitive, stalled policy of privatizing State-Owned Enterprises (SOE). According to the matrix, a Privatization Committee should be established by Presidential Decree this month, and a blueprint for SOE privatization should be drafted by November. Our foreign advisor contact in the Finance Ministry described Minister of State Owned Enterprises Sugiharto as a stumbling block to privatization efforts, saying that Sugiharto would like to create a Temasek-style holding company and will not sell any SOE if he can help it. The advisor said that Sugiharto has had to cede some power, however, and that the divestment committee will no longer be chaired by Sugiharto but by Boediono.

Comment: Less and More

¶20. (SBU) The matrix contains less than earlier drafts the Embassy had seen. This may not be a bad thing, however, as the GOI was criticized for slow implementation of earlier measures which were announced with great fanfare. It would be better for the GOI to take small steps which build credibility in its ability to deliver, rather than broad

strokes which are ultimately realistic. We believe many elements of this new package are feasible, though missing specific benchmarks and targets to measure results.

¶21. (U) This cable was researched and drafted by TDY Economic Officer Juliet Berger.

PASCOE